

No. 9920.

IN THE
United States Circuit Court of Appeals⁹
FOR THE NINTH CIRCUIT

J. HOWARD PORTER, JOHN C. PORTER and PAUL D.
PORTER, identified under the trade name PORTER
PROPERTY TRUSTEES, LTD.,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR PETITIONERS.

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Preliminary Statement.

This appeal is from a decision of the United States Board of Tax Appeals in favor of respondent and against petitioners. The cause involves a deficiency assessed by the Commissioner of Internal Revenue for income and excess-profits tax for the year 1935. The Commissioner held the petitioners to be an association within the meaning of Section 801(a)(2) of the Revenue Act of 1934, and taxable as a corporation. The Board of Tax Appeals affirmed the decision of the Commissioner in this respect by its decision entered March 5, 1941.

The Question Presented.

Are the petitioners a pure trust, taxable as such, or, are they an association, taxable as a corporation, within the meaning of Section 801(a)(2) of the Revenue Act of 1934?

Statutes and Regulations Involved.

Sections refer to Revenue Act of 1934—*Articles* refer to Regulations 86.

Sec. 161.(a) The taxes imposed by this title upon individuals shall apply to the income of * * * any kind of property held in trust, including—

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

(b) The tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary, except as provided in section 166 (relating to revocable trusts) and section 167 (relating to income for benefit of the grantor).

Art. 161-1. Supplement E prescribes that the taxes imposed upon individuals by Title I shall be applicable to the income of * * * any kind of property held in trust (except in the case of those trusts within the scope of sections 165, 166, and 167).
* * *

Sec. 801.(a) When used in this Act—

(2) The term “corporation” includes associations, joint-stock companies, and insurance companies.

* * *

Art. 801-2. The term “association” is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of desig-

nated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an "investment" trust (whether of the fixed or the management type), an inter-insurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

Art. 801-3. The term "trust", as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement where-

by the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action,

of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal", the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form itself. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

Statement of the Case.

A stipulated statement of the evidence is fully set forth at pages 46 to 70, inclusive, of the Transcript of Record. The trust instrument appears at pages 70 to 92, inclusive. No useful purpose would be served by further repetition at this point. However a brief resume of the pertinent facts is as follows:

James Porter, over 70 years of age, and Katie E. Porter, his wife, were the owners of certain property consisting principally of agricultural and unimproved lands in the states of California, Minnesota and Iowa. In 1930 they organized a corporation and transferred the said property thereto in exchange for its capital stock. Some of the lands were thereafter sold on contracts and some improved both prior to and during the time it was held by the corporation. Some farming operations were carried on by lease tenants on a straight rental basis. Some transfer of the shares of capital stock of the corporation were made subsequent to the initial issue and on February 28, 1935 the capital stock of the corporation was held as follows:

Name	Relationship	Shares held
James Porter	Father	685
Katie E. Porter	Mother	1,858
Paul D. Porter	Son	50
B. F. Shumway	Nominee of father	65
W. N. Dennison	Husband of daughter	50
Rebecca P. Wells	Daughter	50
James Howard Porter	Son	50
John C. Porter	Son	0
Elizabeth P. Dennison	Daughter	0
Total shares		<hr/> 2,808

On February 28, 1935, for the purpose of equitably distributing their property to their children, and at the same time give protection to a son who was addicted to the liquor habit [Tr. pp. 51-52], James Porter and Katie E. Porter executed a trust instrument by which they transferred in trust all of the property making up the corpus of this trust. After the trust instrument had been signed by Porter and wife, it was then signed by the trustees in accepting their office and obligation as such. [Tr. p. 52.]

The beneficial interests in the trust were entered in the trust records on the order of James Porter and Katie E. Porter as follows:

Paul D. Porter	290	one	thousandths
John C. Porter	290	“	“
Rebecca P. Wells	65	“	“
Elizabeth P. Dennison	65	“	“
James Howard Porter	290	“	“
	<hr/>		
	1000		

[Tr. pp. 91-92.]

No certificates of beneficial interest, or writings of any kind pertaining thereto, have at any time been issued. [Tr. p. 66.] The record of beneficiaries is never to be changed except in the event of the death of a beneficiary. [Tr. p. 91.]

The trust was entered into by a series of documents and acts all done on February 28, 1935 and completing one transaction.

James Porter and Katie E. Porter signed the trust instrument without the knowledge of the trustees or beneficiaries [Tr. pp. 51-52; 56-58; 61], and then requested the trustees to act as such. They delivered to trustee James Howard Porter 2408 shares of stock in the James Porter Investment Company, which shares were simultaneously surrendered to the James Porter Investment Company in exchange for all of the assets of said company except one parcel situate in Grundy County, Iowa. Said assets consisted of real estate and land contracts. Shortly thereafter the James Porter Investment Company was liquidated and dissolved. [Tr. p. 48.]

Income for the year in question was from farm rentals, from land-owners oil royalties under oil and gas leases on the lands at the inception of the trust, and from interest on contracts receivable, likewise acquired. The same was duly reported. [Tr. p. 50.]

The purpose of the trust as testified to by James Porter, the grantor, was to distribute their property equitably to their children and at the same time give protection to a son who was subject to the liquor habit. [Tr. pp. 51-52, 56.]

Since the appointment of the trustees they have cared for the property entrusted to them. James Howard Por-

ter has been the most active of the three in this respect. He has maintained financial records of receipts and disbursements and has made leases to tenants for the farming of parts of the lands. He has collected rents and has reported to the other trustees when he has happened to see them as to what he has done. The other trustees have looked after some of the land that was located close to them. The beneficiaries have not been consulted nor advised with in connection with the operation of the property. Some distribution to the beneficiaries has been made. Some of the land has been farmed by tenants under terms of leases which have been given them by James Howard Porter, trustee. [Tr. p. 61.] The trustees did not actually farm any of the property themselves. [Tr. p. 62.]

The trustees have attempted to get offers of sale for some of the property both through real estate agents and individuals but have not been able to sell any of the said land. [Tr. p. 62.]

ARGUMENT.

I. The Board of Tax Appeals erred in finding that the petitioners were an association and taxable as a corporation, since the evidence does not support such a finding.

II. Petitioners are trustees of a pure ancestral trust, taxable as such, and are not an association taxable as a corporation.

(a) The trust was established for the purpose of equitably distributing property belonging to aging parents to its natural recipients, their children.

(b) The trust was established for the protection of an incompetent son.

(c) In the management of the trust property, no operation for profit, as distinguished from the collection of income from the use of the properties, were entered into.

(d) There was no association, as the trustees acted only at the instance and request of the grantors, and the trustees and beneficiaries knew nothing of the terms or conditions of the trust at its inception and had nothing to do with its establishment. The beneficiaries have had nothing to do with the operation of the same.

I.

When Congress enacted the Revenue Act of 1934 it clearly specified that a trust was taxable upon an entirely different basis to an "association". Section 161 of said Act provided:

"The taxes imposed by this title upon individuals shall apply to the income of * * * any kind of property held in trust * * * except * * * as relating to revocable trusts * * * and (as) relating to income for benefit of the grantor."

The distinction has been further recognized by the Treasury Department in its Regulation 86, Article 801-3, promulgated under authority of the same revenue act, as follows:

"The term 'trust', as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

"As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the

benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining the advantages of those forms of organization without their disadvantages.

“If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classified by the Act as a corporation. By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as ‘*quasi-corporate form.*’ The effectiveness in action in the case of a trust or of a corporation does not depend upon

technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other 'officer', the use of a 'seal', the issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a 'charter' or 'by-laws', the existence of 'control' by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained in the case of a trust, by the use of the trust form itself. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

"The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed."

The courts have uniformly recognized the distinction made by Congress for the taxation of trusts and have divided the field into two distinct classes.

First there is the Business Trust or "Association" which is adeptly described and defined in

Morrissey v. Commissioner, 296 U. S. 344

wherein the Supreme Court states that the term "association" implies associates who join in a business enterprise for the purpose of transacting business and sharing in its gains. This opinion further defines the distinctive features of an association as being an organization created to enable the participants to carry on a business and divide the gains which accrue from the common undertaking. This class of trusts, of course, is taxable as a corporation.

In the second class we have the Liquidating trust and Ancestral trust which is created for the purpose of conserving, dividing and distributing the family estate and in the meantime carrying on such business as is incidental to the specific property administered. Examples of such trusts have been distinguished in,

Commissioner v. Guitar Trust Estate, 72 Fed. (2d) 544;

Blair v. Wilson Syndicate Trust, 39 Fed. (2d) 43;

Living Funded Trust of Harry E. Lyman v. Comm., 36 B. T. A. 161;

U. S. v. Davidson, 115 Fed. (2d) 799,

where the courts have consistently held that the trusts therein considered were ancestral trusts taxable as pure trusts.

We contend that such is the case with the instant trust and that the findings of the Board of Tax Appeals to the contrary are not supported by the evidence. The gist of the findings appear on page 37 of the transcript wherein the Board states, "A glance at the history of the present trust leaves no doubt that there was here such a purpose." (business purpose.) It goes on to point out that James Porter and wife owned agricultural lands; they created a corporation and took shares in exchange for the lands. All of the shares were held by the Porters, two sons, one daughter, a son-in-law and a nominee (the Porter family). "In 1935 a trust was substituted for the corporation, * * *." "The new trust beneficiaries are still the members of Porter's family, although their relative interests have changed somewhat since the corporation was dissolved."

The findings entirely disregard all evidence that the trust was entered into for the purpose of equitably distributing the estate of aging parents to their children and at the same time protecting a son addicted to the liquor habit. While the Board skips over the evidence and arrives with an unsupported conclusion, the facts in evidence are that in the corporation the Porters owned practically all of the property represented by the stock, only three of their children holding approximately 5%. The creation of the trust and all matters in connection therewith were dictated and carried out by and under the orders of the Porters with the final result that they owned none of the beneficial interest, the same being divided 100% among their five children. Of course the land did not drop its identity. It was the same soil. Also it was

still owned by “members of Porter’s family” but each member is a distinct individual and holds in his own right.

Again the Board looks back to the corporation [Tr. p. 40] when it says:

“* * * , we need look only beyond the creation of the trust to the prior corporation to find parents and children happily associated together under the form of a corporation in carrying on their farming operations. In the transmutations which followed it would seem of little moment that certain members of the family passed from the active role of shareholders to the passive one of beneficiaries.”

We know of no rule of law whereby property once titled in a corporation acquires a disability which prevents it from again going into private ownership.

II.

Petitioners are trustees of a pure ancestral trust, taxable as such, and are not an association taxable as a corporation.

Generally, three tests have been found in the Treasury Department regulations to aid in arriving at the conclusion as to whether or not a trust is an “association” within the meaning of the revenue act. These are (a) Purpose; (b) Actual operation; (c) Form of organization.

Commissioner v. Vandergrift Realty & Inv. Co.,
82 Fed. (2d) 387.

The Court in this case at page 390, says:

“There can hardly be a serious question as to the fact that the trust (Vandergrift) was carried on under a corporate form, but the Supreme Court indi-

cates very clearly in *Morrissey v. Commissioner* (56 S. Ct. 289) that little consideration should be given to the form or organization under which the trust is operated, but rather that the true rule is that purpose and actual operation of the trust should be controlling in determining whether or not the trust shall be classified as an association for tax purposes.”

In the instant trust the property constituting the corpus was once titled in a corporation but by a series of instruments and acts all done at the same time and constituting one transaction [Tr. p. 48] the actual property was titled in the trustees and the corporation dissolved. The ownership of the property both legal and equitable changed completely and the resulting transaction was a gift in trust from James Porter and wife to their five children. The law recognized a completed transaction by one or more acts or instruments as one transaction and looks through the actual form of said separate acts to get the purpose and net result of the accomplishment.

Lewis v. Commissioner, 301 U. S. 385.

The purpose of the trust is definitely stated by the grantor James Porter. He consulted with his attorney and with Mrs. Porter and decided to establish the trust; they had the papers prepared, and signed the same after which they requested the trustees to act and at the same time secured the deed to specific property to make up the corpus of the trust. Porter and wife at the same time signed an order to register their five children as beneficiaries under the terms of the trust to thereby equitably distri-

bute their property that was going into the trust among their five children [Tr. p. 52], and also give protection to a son who was addicted to the liquor habit [Tr. p. 56]. The fact that it may or may not have accomplished any change in taxing basis is immaterial. There is neither law nor prejudice against any person taking advantage of any legitimate means to change his status for tax purposes.

It is submitted that the purpose of the trust was worthy as well as legal and that the same falls directly within the classification of ancestral trusts as outlined in *Comm. v. Guitar*; *Blair v. Wilson Syndicate*; *Lyman v. Commissioner*; and *U. S. v. Davidson, supra*. Now let us look to the operation.

All evidence as to the operation of the trust is found in the testimony of James Howard Porter, one of the trustees. He has been in charge of the trust property since the inception of the trust. He has kept records of income and disbursements with the aid of a bookkeeper. The trustees never held any formal meetings but saw each other occasionally. No meetings were held with beneficiaries nor were they advised with in connection with the conduct of the affairs of the trust. The property belonging to the trust is practically all farm land and some of the land has been farmed by lease tenant farmers under terms of leases which the trustees made with them. None of the lands were farmed by the trustees. The trustees collected rents due to the trust and have made some disbursements to the beneficiaries. They also made some effort to sell part of the property but no sales were made. [Tr. pp. 60-70.]

It will plainly appear that the activity of the trust has been strictly limited to the normal care incidental to the property belonging thereto. No business was carried on. No farming activities were engaged in. Part of the land was simply rented to tenants on a lease basis, the rents collected and the money disbursed, some of it being distributed to beneficiaries. The business activity was nominal and certainly by any stretch of the imagination cannot be extended to indicate that the trust was engaged in a business undertaking.

In *United States v. Davidson, supra*, the trust property consisted of corporate stocks; bonds and notes; bank deposits; the capital stock of two sugar companies; and loans to these companies and to the Davidson Steamship Company. James E. Davidson, trustee of the trust, became general manager of these companies. During the life of the trust large sums of money were loaned to these various companies to protect money already loaned to them. The trustee loaned large amounts to the steamship company for the purpose of protecting and preserving vessels until they could be sold. When they were sold the loans were repaid. The trustee kept on hand large amounts of money with which to meet contingencies and from time to time invested in securities. The trial court found that these investments were not made "with a view to market profits; that his investments were not of a nature or volume to classify him as a banker, broker, trader or money lender; that he had done no more than hold and attempt to preserve the trust property and receive the ordinary fruits of its ownership and that this was incidental to the ultimate liquidation and distribution of the property."

The case at bar presents a similar situation but with even lesser business activity. The property involved was put to its normal use by lease tenants. The trustee's duties were in all respects ministerial. He entered into simple leases covering the property, collected the rents and disbursed the proceeds.

Conclusion.

We conclude that the purpose of the instant trust was to distribute to its natural recipients the property belonging to an aging father and mother, that the operation of the trust has only involved such activity as was incidental to the property and that the trustees have done no more than to receive the ordinary fruits of its ownership. The trust is not and has not been engaged in business and is not an association as contemplated by the Revenue Act of 1934. It is therefore not taxable as a corporation.

Respectfully submitted,

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